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SUBJECT: UPDATE ON NICARAGUA'S DOMESTIC DEBT

REF: MANAGUA 371

11. (SBU) Summary: Working with the U.S. Department of Treasury's Office of Technical Assistance (OTA), Nicaragua is taking the first steps in addressing its excessive domestic debt burden. The OTA designed National Debt Management Strategy aims to develop an internal market for government debt to serve as a strong financing alternative for the GON once HIPC/IDA-only concessional terms are phased out. The 2007 auction schedule calls for USD 40 million in one- and three-year instruments and USD 40 - 60 million a year for the next three years. The issuances will have staggered maturity dates, hopefully creating a domestic yield curve and promoting a domestic secondary bond market. While at this point, bond-based government debt is more expensive than the concessional loans currently available, establishing a regular market for these domestic instruments will provide Nicaragua with a cheaper financing alternative in the future. End Summary.

12. (U) Nicaragua is taking the first steps in addressing its excessive domestic debt burden. In 2006, Nicaragua's internal debt reached USD 1.2 billion (equivalent to 23% of GDP). Despite President Ortega's rhetoric regarding "foreign and domestic oligarchic creditors," the GON has kept its domestic debt repayment schedule. In February, it paid USD 124.3 million in Property Indemnification Bonds (BPI - bonds issued as compensation for lands seized in the 1980s). In May, it paid USD 21.7 million in bank bonds (CENIs - used to cover costs of four bank failures in 2001-2).

13. (SBU) Since 2002 the U.S. Department of Treasury's Office of Technical Assistance (OTA) has been working with the Central Bank (BCN) and the Ministry of Finance (MHCP) to create a National Debt Management Strategy (DMS) to develop a more sustainable program for domestic public debt and to address the problem of ballooning debt payments in 2008 and 2009. (Note: Nicaragua's debt service will increase to USD 187.2 million in 2008 and USD 175 million in 2009 due primarily to the maturation of BPIs. End note.) In 2004-5, in an attempt to develop a local market for government debt instruments, MHCP issued USD 16 million in short-term bills ("letras") but detected a lack of demand for medium-term bonds. This lack of demand in the medium-term instruments was most likely due to the controversy surrounding the CENIs and the lack of consistency and transparency in the 2004-5 issuances.

A New Debt Management Strategy

14. (SBU) In 2007 the GON prioritized the OTA-designed DMS, whose primary objective is the development of an internal market for

government debt to serve as a strong financing alternative for the GON once HIPC/IDA-only concessional terms are phased out for Nicaragua. In May the Economic Cabinet approved the MHCP domestic debt auction calendar for 2007, allowing MHCP to raise USD 40 million this year. (Note: These include both competitive and non-competitive auctions. End note.)

¶5. (SBU) An essential part of the DMS will be a regular dialog between MHCP and investors in order to improve demand and liquidity for government bonds, increase transparency in the process, and promote the development of an active secondary market. Five basic components of the DMS are:

-- MHCP will only issue standardized bonds.

-- Issues will be concentrated in fewer series in order to increase their liquidity.

-- Time periods for the bonds will be extended gradually. (i.e. in 2007, MHCP will only issue one and three-year bonds.)

-- MHCP will issue a quarterly report on the auction plan and calendar.

-- Communication with investors will be improved by creating a government-investors consultation mechanism; they will meet regularly with the principal market players.

¶6. (SBU) The auction schedule for 2007 includes USD 10 million in Treasury Bills and USD 30 million in Republic of Nicaragua Bonds. The Bills will be in denominations of USD 10,000 and mature in one year with payment in cordobas at the prevailing official exchange rate. The Republic of Nicaragua Bonds will be in denominations of USD 10,000 and will mature in three years. Payment will be in cordobas with interest paid out every six months.

Bond Issuances in 2007

¶7. (SBU) The Central Bank will continue to issue its own paper, all with maturities of less than one year (one, three, and six months.) As of May 23, BCN had placed short-term bills valued at USD 80.6 million for 2007. The growing demand for BCN paper has allowed it to start lowering the rates it accepts for its bonds (i.e. cutoff rates.) (Note: The DMS calls for a gradual phase-out of BCN issued paper and increased use of MHCP's bonds to support monetary policy. End note.)

¶8. (SBU) MHCP has already begun implementing the DMS. In May it issued USD 10 million in one-year bills. All but 800,000 were placed. (Note: The final bonds were sold in June. End note.) 65% was placed in a non-competitive auction and 35% through a competitive process. In both auctions the rates came in at under 10%, lower than expected. MHCP will auction USD 30 million in three-year Republic of Nicaragua Bonds in the fall, with private banks among their target audience. The current plan is to issue USD 40 - 60 million a year for the next three years, with staggered maturity dates, to create a domestic yield curve and promote a domestic secondary bond market. (Note: Nicaragua has a securities exchange where bonds are traded, and the National Assembly passed a Capital Markets Law in 2006, both of which will facilitate this process and eventually lead to a commercial debt market. End Note.)

¶9. (SBU) To address the upcoming balloon payments, MHCP plans an additional auction to raise the funds to buy back BPIs with 10-15 year maturities, which currently trade at about 40 cents on the dollar. BPIs currently represent over 80% of the domestic government debt and the buy-back would represent a huge savings for the GON. OTA is focusing MHCP on issuing only standard paper for all of the GON's financial needs and avoid past habits of special types of bonds for different situations (i.e. BPIs, CENIS).

¶10. (U) OTA and MHC believe that this additional auction to cover the BPIs should be successful as private banks currently have excess liquidity due to high deposits, but lower demand for credit.

¶11. (U) Information on BCN and MHCP bonds can be found at:
http://www.bcn.gob.ni/titulos_valores/

Conclusion

¶12. (SBU) While at this point, bond-based government debt is more expensive than the concessional loans currently available under HIPC/IDA terms, establishing a regular market for these domestic instruments is essential for the time when Nicaragua no longer qualifies for concessional loans. An established bond market will provide the GON with a much cheaper alternative to raising needed funds than the regular loan market. Success of this plan will depend on presenting a coherent economic plan and keeping stable macroeconomic policies in place.

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